

**General Information Letter:** Computation of addition modification for life insurance companies subject to Section 832 haircut.

March 9, 1998

Dear:

This is in response to your letter dated February 26, 1998, in which you request a letter ruling. Department of Revenue ("Department") regulations require that the Department issue only two types of letter rulings, Private Letter Rulings ("PLRs") and General Information Letters ("GILs"). PLRs are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. GILs do not constitute statements of agency policy that apply, interpret or prescribe the tax laws and are not binding on the Department. For your general information we have enclosed a copy of 2 Ill. Adm. Code Part 1200 regarding rulings and other information issued by the Department.

Although you have not specifically requested either type of ruling, the nature of your question and the information provided require that we respond only with a GIL.

In your letter you have stated the following:

I am requesting a ruling regarding the addition of tax exempt interest to federal taxable income in the computation of Illinois taxable income.

Xxxxxxxx xxxx xxxxxxxxxxxxxxx xxxxxxxx (Hereinafter "xxxxxxx"), FEIN xx-xxxxxxx, is a reinsurance company taxed as a life insurance company. xxxxxxxx earns substantial income from tax exempt sources (i.e. state and municipal bonds). All tax exempt interest is included in gross investment income in accordance with I.R.C. 812(d) (See Federal Form 1120-L, Schedule B, Line 9).

Pursuant to 35 ILCS 5/203(b)(2) an addition to taxable income should be made for all "amounts paid or accrued to the taxpayer as interest and all distributions received from regulated investment companies during the year to the extent excluded from gross income in the computation of taxable income." This section is modified by 35 ILCS 5/203(b)(3) in the case of a life insurance company by substituting "gross investment income" for "gross income" in the preceding section.

It would appear based on 35 ILCS 5/203(b)(2) and (3), that if xxxxxxxx includes all federally tax exempt interest income in gross investment income, no addition for tax exempt interest would be required. Is this the proper treatment?

## Ruling

Section 203(b) of the Illinois Income Tax Act (the "IITA"; 35 ILCS 5/101 *et seq.*) provides:

(1) In general. In the case of a corporation, base income means an amount equal to the taxpayer's taxable income for the taxable year as modified by paragraph (2).

(2) Modifications. The taxable income referred to in paragraph (1) shall be modified by adding thereto the sum of the following amounts:

(A) An amount equal to all amounts paid or accrued to the taxpayer as interest and all distributions received from regulated investment companies during the taxable year to the extent excluded from gross income in the computation of taxable income;

\* \* \*

(3) Special rule. For purposes of paragraph (2) (A), "gross income" in the case of a life insurance company, for tax years ending on and after December 31, 1994, shall mean the gross investment income for the taxable year.

Section 812(d) of the Internal Revenue Code, which is contained in the life insurance company taxation provisions of Part I of Subchapter L, provides that:

For purposes of this section, the term "gross investment income" means the sum of the following:

(1) INTEREST, ETC. -- The gross amount of income from --

(A) interest (including tax-exempt interest), dividends, rents, and royalties . . .

Section 102 of the IITA provides that:

Except as otherwise expressly provided or clearly appearing from the context, any term used in this Act shall have the same meaning as when used in a comparable context in the United States Internal Revenue Code of 1954 or any successor law or laws relating to federal income taxes and other provisions of the statutes of the United States relating to federal income taxes as such Code, laws and statutes are in effect for the taxable year.

Under this provision, a reference in the IITA to "gross investment income" of a life insurance company would generally have the same meaning as that term has in Section 812(d) of the Internal Revenue Code. "Gross investment income" would therefore include interest which is generally exempt from tax under Section 103 of the Internal Revenue Code. However, the context in which that term is used in the IITA indicates that it does not have the same meaning as that term is given in Section 812(d) of the Internal Revenue Code.

From the time it was enacted in 1969 until it was amended by Public Act 88-648, Section 203(b)(3) of the IITA provided that:

(3) Special rule. For purposes of paragraph (2) (A), "gross income" in the case of a life insurance company shall mean the company's share of the gross investment income for the taxable year.

In the Official Commentary on the Illinois Income Tax Act, as originally enacted, this provision was explained as follows:

[I]n the case of an insurance company, a special rule provides that only that federally excluded interest which is allocable to the company is added back to federal taxable income in the computation of base income. Thus, the company is not exposed to tax on the amount of federally excluded interest which is properly allocable to policyholders.

This explanation of Section 203(b)(3) was referring to the fact that, under Section 802(b) of the Internal Revenue Code of 1954, as in effect during 1969, "taxable investment income" included in "life insurance company taxable income" was computed by apportioning interest, dividends and other returns on investments between the life insurance company and its policyholders, with only the life insurance company's share being included in "taxable investment income." See Section 804(a)(2) of the Internal Revenue Code of 1954, as enacted in Public Law 86-69, which defined "taxable investment income" to mean:

an amount (not less than zero) equal to the sum of the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), reduced by --

(A) the sum of --

(i) the life insurance company's share of interest which under section 103 is excluded from gross income . . .

Under Section 804(a), the life insurance company's share of investment returns was determined by dividing policy liabilities by the "investment yield," to determine the policy holders' share, and then subtracting that amount from 100%. "Investment yield" was defined in Section 804(c) to mean "gross investment income" minus specified expenses. "Gross investment income," in turn, was defined in Section 804(b) to include all interest income, including tax-exempt interest.

Effective for taxable years ending after December 31, 1983, Public Law 98-369 substantially revised the provisions for taxation of life insurance companies. Among other things, the apportionment of investment income between the policyholders' share and the life insurance company's share for purposes of computing an amount of "taxable investment income" was eliminated. However, for some purposes, various items are still apportioned between policyholders and the life insurance company using a formula based on "gross investment income," which continues to include exempt interest income. See Section 812(d) of the Internal Revenue Code, as in effect since the enactment of Public Law 98-369.

Public Act 88-648 amended Section 203(b)(3) of the IITA to take into account the fact that there no longer was a "policyholders' share" of exempt interest which should not be added back to a life insurance company's taxable income because that income was not attributed to the life insurance company under the Internal Revenue Code. See the statement of Senator Madigan in the General Assembly Debate Transcript for May 13, 1994 at pages 18 and 19.

Thus, a review of the history of the IITA and the Internal Revenue Code shows that, for the entire time the IITA has been in effect, the Internal Revenue Code has contained a definition of the term "gross investment income" of a life insurance company which includes otherwise tax-exempt interest in that term. If that term as used in Section 203(b)(3) were intended to have the same meaning as the federal term, that subsection would have been meaningless. The only purpose of Section 203(b)(3) in the original IITA was to limit the application of the provision requiring the add-back of tax-exempt income to the insurance company's share, and thus to exclude the policyholder's share, of interest excluded from "gross investment income." Since "gross investment income" under Section 804(b) included tax-exempt interest, using the federal definition would mean there would never be anything to add back under that definition, either policyholders' share or life insurance company's share.

Similarly, the amendment of Section 203(b)(3) by Public Act 88-648 was intended to clarify that all tax-exempt interest of a life insurance company should be added back, to the extent excluded from "gross investment income" without any exclusion for "policyholders' share" of such income. Again, if "gross investment income" were to have the same meaning as used in Section 812(d) of the Internal Revenue Code, this provision would be meaningless.

Accordingly, all interest income which is excluded from the federal taxable income of a life insurance company under Section 103 of the Internal Revenue Code must be added back in the computation of the company's base income under Section 203(b)(2)(A).

As stated above, this is a GIL which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you wish to obtain a PLR which will bind the Department with respect to the application of the law to specific facts, please submit a request conforming to the requirements of 2 Ill. Adm. Code Part 1200. Please note, however, that a PLR cannot apply the law to a hypothetical situation and a PLR is not binding with respect to a statement of facts which is incomplete or incorrect.

Sincerely,

Paul S. Caselton  
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